A Mechanism to Regulate Sovereign Debt Restructuring in the Euro Area


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GCEE proposal „Maastricht 2.0“: Necessary elements for a stable framework that retains national fiscal sovereignty.

Fiscal and economic policy
- No-bailout clause
- Strengthening of the market discipline
- Reformed Stability and Growth Pact
- Preventive and corrective arm
- Fiscal compact
- National debt brakes

Crisis mechanism
- European Stability Mechanism (ESM)
- Sovereign Insolvency mechanism
  - Linkages: financial support in case of sovereign insolvency
  - Ex-ante conditional liquidity support (compliance with Stability and Growth Pact)
  - Financial back-up for bank restructuring

Financial framework
- European banking union
  - Supervisor
  - Restructuring and resolution
  - Restructuring fund
  - But: national deposit guarantees schemes

Accompanying measure
- Phase-out of regulatory privileges for sovereign bonds

National responsibility

European responsibility
GCEE proposes a package of measures for a stable framework that retains national fiscal sovereignty.

- **Bail-in invoked as part of ESM programmes**
  - Enhance ESM fire power
  - Protect ESM funds

**Fiscal and economic policy**
- No-bailout clause
- Strengthening of the market discipline
- Reformed Stability and Growth Pact
- Preventive and corrective arm

**Crisis mechanism**
- European Stability Mechanism (ESM)
- Creditor Participation Clauses
  - Linkages: Financial assistance of source Countries
  - Loans

**Financial framework**
- European banking union
  - Supervision
  - Restructuring and resolution
  - Restructuring fund
  - Statutory national deposit guarantees schemes
- Accompanying measures

- Reduce dead weight loss from restructuring
- Share burden more evenly
- Anchor market expectations
- Avoid legal tussles

**Example: Euro area Troika programmes**

- €142 billion for debt repayments as per initial programme projection
- 62 (Greece), 21 (Ireland), and 64 % (Portugal) of total funding needs

**Financing needs** during the crises in Greece, Ireland and Portugal

1. Sum of general government deficit and amortisation of long-term debt securities.
2. Greece: including PS borrowing need.
3. a – May, December; b – January, June; c – including December 2013, d – June, December

SOURCES: European Commission and own calculations
Existing proposals (selection)

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Year</th>
<th>Authors</th>
<th>What aspects does the proposal address?</th>
<th>Setting triggers</th>
<th>Calibrating debt relief</th>
<th>Preventing holdouts</th>
<th>Facilitate transition</th>
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</thead>
<tbody>
<tr>
<td>European Debt Restructuring Mechanism</td>
<td>2010</td>
<td>Weder di Mauro, Zettelkühler</td>
<td>ESM, 2 hard thresholds</td>
<td>Court decides</td>
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<tr>
<td>European Crisis Resolution Mechanism (ECRM)</td>
<td>2010</td>
<td>Gianviti, Krueger, Pisany-Ferry, Sapri, von Hagen</td>
<td>Court decides</td>
<td></td>
<td></td>
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<tr>
<td>European Monetary Fund (EMF)</td>
<td>2010</td>
<td>Gros, Mayer</td>
<td>EMF, Guarantee &lt;50% GDP</td>
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<tr>
<td>European Stability Mechanism</td>
<td>2011</td>
<td>Corsetti, Devereux, Hassler, Saint-Paul, Sinn, Sturm, Vives</td>
<td>ESM, soft 3-stage</td>
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<tr>
<td>Trigger clauses</td>
<td>2011</td>
<td>Weber, Ulbrich, Wodendorf</td>
<td>ESM, 3-year extension</td>
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<tr>
<td>European Sovereign Debt Restructuring Mechanism</td>
<td>2013</td>
<td>Buchheit, Gelbmann, Gulati, Panizza, Weder di Mauro, Zettelkühler</td>
<td>ESM, hard threshold</td>
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<td>Viable Insolvency Procedure for Sovereigns</td>
<td>2014</td>
<td>Fuest, Heinemann, Schroder</td>
<td>ESM, soft</td>
<td>ESM, hard</td>
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<tr>
<td>MEZ proposal</td>
<td>2015</td>
<td>Corsetti, Feld, Lane, Reichlin, Rey, Vayanos, Weder di Mauro</td>
<td>ESM, hard threshold</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: Authors.

Time line

1. Programme request
   ESM Programme with strict conditionality
2. Debt sustainability analysis by ESM
3. First stage debt operation
   • Eligible debt > 60.90% GDP or
   • Eligible debt funding requirement > 15.20% GDP or
   • 2.5 variations of fiscal rules in last 5 years
4. Maturity extension for duration of programme
5. Second stage debt operation if necessary
   • Based on debt sustainability analysis by ESM
   • Completed before programme end
6. Deeper debt restructuring

1 – Newly issued debt including Creditor Participation Clauses.
Source: Authors
Implementation

- Principle of private sector involvement already in place
  
  Preamble (12), ESM Treaty: “In accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered.”
  - Mirroring IMF new lending framework agreed by 189 member countries

- Legal/regulatory foundation
  - New class of bonds with single-limb voting CACs
  - Enforcement moratorium to be anchored in ESM Treaty
  - Also: retain possibility to restructure old debt and limit coupon payments
  - Also: phase out privileges for sovereign exposures in banking regulations
  - Also: keep ECB liquidity window open to bonds with maturity extension

Phase-in (1)

- Transition: phase-in through introduction of new clauses
  - Applies only to sovereign bonds issued by central governments

Maturing long term sovereign bonds¹:

<table>
<thead>
<tr>
<th>Year</th>
<th>Belgium</th>
<th>France</th>
<th>Germany</th>
<th>Ireland</th>
<th>Italy</th>
<th>Portugal</th>
<th>Spain</th>
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</thead>
<tbody>
<tr>
<td>2016</td>
<td>6.8</td>
<td>3.3</td>
<td>2.1</td>
<td>0.9</td>
<td>1.2</td>
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¹ - Sample of long term sovereign bonds issued by central governments since 1999 as of end-2014. Figure for year 2030 includes all amounts maturing in 2030 or later in % of 2030 GDP.

Source: Eidam (2016)
Phase-in (2)

Penetration of debt stock with bonds including Creditor Participation Clauses (CPCs) issued from 2017

1 - Assumes bonds are issued with new clauses starting in 2017 based on maturity profile for bonds as of end 2014, with (i) maturity of newly issued bonds similar to 2014 and (ii) nominal debt following European Commission (2015) and extrapolated from 2027. 2 – Assumes that shares of other debt relative to GDP remain constant. 3 – Deficits until 2026 based on European Commission (2015), and converging towards 0.5% of GDP at a speed of 0.5 percentage points afterwards. Bonds with CPCs falling due are rolled into similar bonds.

Source: Eichengreen (2016)

Who shares the burden?

Holders of advanced economy government debts, 2015Q2

- Mostly intra-euro holdings differ from EM restructurings, but:
  - Too big to be saved issue (e.g., Italy?)
  - Reduce uncertainty (→ indirect spillovers)
What are the risks of spillovers?

Interest rate spreads on government bonds compared to Germany\textsuperscript{1}

![Graph showing interest rate spreads on government bonds compared to Germany.](image)

1. Differences between the yield on 10-year government bonds of each country relative to German government bonds.
Source: Thomson Financial Database

- Serious valuation effects even absent restructuring mechanism

How serious are losses in the long run?

- Long-term investors can benefit from upside following crisis resolution

![Graph showing frequency distribution of sovereign bond returns by type of crisis resolution.](image)

1. Periods during a five-year window ending 200 working days prior to crisis and ending 200 days after crisis end. Sample countries include Argentina (2001), Brazil (2001-2002, 2008), Mexico (2001), Turkey, Korea, Russia (2001), Indonesia, Malaysia, Singapore, Philippines, Brazil, Russia, Ukraine, Bulgaria, Hungary, Romania, Poland, Czech Republic, Slovakia, Hungary, Hungary, Bosnia, Croatia, Czech Republic, Hungary, Hungary, Hungary, Hungary, Hungary, Hungary, Hungary, Hungary, Hungary, Hungary, Hungary.


Source: Anand, Devala, and Rammohan (2010).
Complementary measures and questions

- Mechanism for clear rules of the game, augmented by…
  - Phase out regulatory privileges (home bias may be endogenous)
  - Promote creation of buffers, e.g. insurance sector?
  - Apply stress test and crisis simulations
- Does the mechanism deter requests for ESM assistance?
  - More room for gradual fiscal adjustment and longer programmes
  - ESM programme needs to take spillovers into account
  - No decision on deeper restructuring needed at ESM programme inception
- What about fiscal discretion and funding costs?
  - No Trojan horse to restrain fiscal policy, national responsibility for fiscal policy
  - Scarce evidence for general increase in funding cost or market volatility

Thank you!